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SENSITIVE
SIPDIS

DEPT PASS TO SENATE FINANCE COMMITTEE FOR AMBER COTTLE AND
AYESHA KHANNA, ALSO USTR FOR LUIS JIMENEZ
NAIROBI PASS TO CHELSEA THOMAS

E.O. 12958: N/A
TAGS: OTRA ECON ETRD EAID PGOV ET
SUBJECT: SCENESETTER FOR STAFFDEL THOMAS VISIT TO ETHIOPIA

REF: STATE 78923

SUMMARY

¶1. (SBU) Your visit to Addis Ababa comes at a challenging time for the Ethiopian economy. Average inflation stands at 36 percent -- the second highest in Africa, after Zimbabwe. Despite two rounds of devaluation of the Birr by 10 percent each this year, the real exchange rate remains overvalued. Foreign exchange reserves stand at nearly two months of import coverage -- a significant improvement from six months ago -- that stems from an imposed stranglehold over lending to the private sector. Real interest rates remain strongly negative. Power-shedding due to inadequate electricity generation capacity over the past three months has forced manufacturing and a significant portion of business activity to slow to a stutter. The global economic downturn has only exacerbated the economy's own challenges. While AGOA exports have more than doubled since last year, to $18 million, the bulk of these are in the "leading sectors" which the Ethiopian Government (GoE) has endorsed and liberalized. Broader exports have stayed flat, despite projections of 25 percent growth. With exports of only $1.5 billion compared to nearly $7 billion in imports, Ethiopia's trade imbalance is dire and growing. End Summary.

GENERAL OVERVIEW OF THE ECONOMY

¶2. (SBU) Ethiopia remains one of the poorest countries in the world. In 2008 its Gross Domestic Product (GDP) was approximately USD 25.7 billion, with per capita GDP of USD
¶324. Chronic cycles of drought, high population growth, state and ruling party dominance in numerous commercial sectors, inefficient agricultural markets, and ever increasing power outages all act to limit Ethiopia's economic development. The agricultural sector comprises 45 percent of GDP and employs 85 percent of Ethiopia's 79 million people. Although Ethiopia's economy is relatively small, it is growing at a fast pace. The GoE publicly touts that Ethiopia has experienced double-digit real GDP growth of over 11 percent in recent years. The GoE predicts real GDP growth of 10 percent this year. Many institutions, including the World Bank and IMF, dispute the GoE's growth statistics, stating that Ethiopia's real GDP growth rate will most likely range between six and seven percent this year.

¶3. (SBU) Total exports have increased over 20 percent per annum on average in the past five years. Total exports this year, remained flat over last year's level of $1.5 billion. Coffee exports -- Ethiopia's major export earner -- are down 25% from last year. The GoE blames coffee exporters (who were allegedly hoarding supply) for the decline in exports and as a result, revoked licenses of six major exporters, detained some company owners overnight, closed the warehouses of over eighty firms, and confiscated their coffee stocks to export directly from the GoE. Despite historical export growth, the country suffers a severe trade deficit year after year. Imports totaled USD 6.8 billion in 2008, creating a trade imbalance of USD 5.3 billion. Ethiopia mainly imports machinery, fuel, and consumer goods.

THE GOVERNMENT'S ROLE IN THE ECONOMY

¶4. (SBU) Since the early 1990's, Ethiopia has pursued a development strategy based on a mixed economy of both state and private enterprises. While the private sector role is expanding, the state remains heavily involved in most economic sectors and parastatal and ruling-party affiliated companies continue to dominate trade and industry, hampering full and free competition. All land in the country remains state owned, although long-term leasing arrangements and rural land registration for farmers have improved in recent years. Foreign investment restrictions are widespread, including key sectors such as banking, insurance, and telecommunications. The state-owned Ethiopian

Telecommunications Corporation (ETC) is the only service provider in the sector, creating an environment of poor telecom service and access. In a country of nearly 80 million people, there are only 920,000 fixed phone lines, 1.8 million cell phones, and 29,000 internet connections. The GoE maintains a hard line stance on these key sectors, but some eventual liberalization may take place as part of the ongoing World Trade Organization (WTO) accession negotiation.

¶5. (SBU) The GoE alone has selected the "leading sectors" in the economy. These are: 1) hides, skins, and leather; 2) pulses and oilseeds; 3) floriculture and horticulture; 4) textiles; and 5) coffee. In these sectors, the GoE has liberalized significantly: inviting foreign investment; offering attractive investment incentives; and generously allocating land, credit, and support. As a result of opening up such sectors -- which are geared toward increasing exports and foreign exchange -- these sectors generally have flourished. Whereas each new investor in these sectors continues to enjoy robust incentives and support, investors interested in doing business in other sectors, businesses focused on domestic demand, or even entrepreneurial investors in new sectors continue to be impeded by near-constant bureaucratic obstacles to doing business in Ethiopia. In many cases, sectors are further restricted to Ethiopian investors, and in some, to the GoE only. As a recent sign of potential diversification from the leading export sectors, GoE officials have begun to mention applying import substitution theory as an alternative means to reduce the trade deficit and increase foreign exchange reserves.

A FUNDAMENTAL MACROECONOMIC IMBALANCE

¶6. (SBU) Against this ideological foundation, state control, and skewed incentives, it is no surprise that the Ethiopian economy faces a fundamental macroeconomic imbalance. By mandating low interest rates, and representing the dominant borrowing force in the country, for years the GoE has ensured cheap credit for itself through highly-negative real interest rates. By so enabling excess demand and accommodating it with excess liquidity, Ethiopia has seen a spike in inflation for the past three years. Year-on-year inflation peaked in

August 2008 at 64 percent. While last year's high prices have limited year-on-year inflation now to single digits, the 12-month average inflation rate remains at 36 percent. The reluctance of the GoE to adjust its fixed peg exchange rate to accommodate this inflation has resulted in a real exchange rate that was as much as 40 percent overvalued in late-2008. The external imbalance which this induced brought foreign exchange reserves to a perilously low level of two weeks of import coverage. The resulting crisis forced the GoE to seek IMF assistance and advice. Two rounds each of 10 percent devaluation of the Birr (against its U.S. dollar peg) have helped re-build reserves, but have come only on the eve of IMF Board votes on assistance to Ethiopia.

¶7. (SBU) The exogenous global commodities price shock of 2008 exacerbated Ethiopia's endogenous economic crisis. While the GoE has become more forthcoming with IMF and World Bank officials in opening its books, it is clear that the GoE is more willing to meet nominal macroeconomic targets through false growth figures and further strangling the private sector than in fundamentally addressing the ideologically-driven policies that have caused the fundamental imbalance. To suppress inflation and re-build foreign exchange reserves, the GoE imposed a credit cap on all banks in May, limiting lent-out capital to levels prevailing on the day of the directive. Despite promises to permit the repatriation of profits, the central bank does not allocate adequate foreign exchange to commercial banks to effect such hard currency payments. To stand by its pledge of keeping deficit spending at zero, the GoE initiated a fierce crack-down on the private sector to expand state revenues. National and foreign enterprises alike have been given previous-year tax bills of up to tens of millions of dollars after secret "desk audits." Some of these come after firms had already been audited for the tax year. Finally,

with the growing international scrutiny over the government's books, the GoE and SOEs are increasingly turning to China for soft loans and awarding Chinese firms with lucrative contracts -- including many which are sole-sourced, non-competed contracts for major infrastructure projects. American firms routinely complain that Ethiopia's government monopoly telecommunications system is inconsistent and inadequate and the absence of international banks only exacerbate the disincentives to invest posed by bureaucratic and state-imposed impediments.

THE DOMESTIC POLITICAL ENVIRONMENT

¶8. (SBU) The May 2005 elections and their aftermath continue to weigh heavily on Ethiopia's domestic political scene. The U.S. Embassy has strongly advocated for transparent and open national elections in 2010, the next major milestone in Ethiopia's democratization process. 2005 saw the opposition take 170 seats in the 547 seat national parliament, a dramatic increase over the 15 seats they held for the previous decade. While the run-up to these elections was the most free and fair in Ethiopia's history, electoral irregularities prompted the opposition to launch an organized civil disobedience campaign that turned violent when confronted by security forces. These security forces killed nearly 200 protesters, detained more than 30,000 suspected demonstrators, and arrested most of the opposition leadership, charging them with capital crimes ranging from treason and genocide to "outrages against the constitution." The leaders were tried and found guilty, but pardoned in ¶2007. Some of the leaders stayed in Ethiopia, but others left and are now advocating for a change of government "by any means necessary." Since 2005, the government has enacted laws which limit and restrict party politics, the media, and civil society, including a law limiting the ability of civil society organizations (NGOs) to receive funding from foreign sources and participate in the political process. The April 2008 local elections saw the ruling party take over all but

three of over three million seats. The next national
elections are scheduled for May 2010.

U.S. ASSISTANCE TO ETHIOPIA

¶9. (SBU) Ethiopia is now the second largest recipient of U.S. foreign assistance in sub-Saharan Africa. The preponderance of this assistance is humanitarian, including food aid, the President's Emergency Plan for AIDS Relief (PEPFAR), the Child Survival and Health Program Funds (CSH), of which a significant share supplements the Government of Ethiopia budget. Relatively little assistance, about five percent of the total, directly contributes to Ethiopia's internal economic stability and sustainable growth. Assistance designed to promote economic stability concentrates on agricultural development -- particularly in vulnerable, conflict-prone areas, in order to achieve food security -- and on healthcare services. Notably, the operating environment and transaction costs for non-budgetary foreign aid are increasing, as a result of new GoE restrictions on non-governmental organization (NGO) implementing partners.
GONZALES